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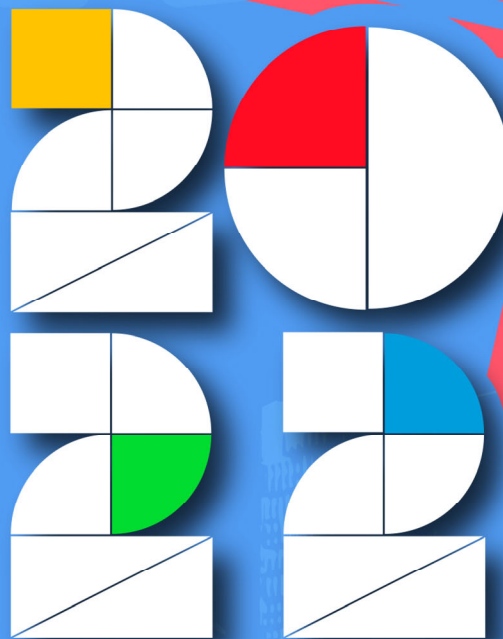
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Reengineering
Knowledge &
Creativity for
Global Excellence

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June



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TeSSH 2022***

**Reengineering Knowledge and Creativity
for Global Excellence**

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Foreword

The papers compiled in these e-proceedings are papers presented online at Technology, Science, Social Sciences and Humanities International Conference 2022 (TeSSH I 2022) held on 30 June 2022 at Universiti Teknologi MARA (UiTM) Cawangan Kedah, Kedah, Malaysia. With the theme, ***Reengineering Knowledge and Creativity for Global Excellence***, the conference has brought together presenters of diverse background who shared their conceptual and empirical papers in broad areas that are subsumed under the fields of Technology, Science, Social Sciences and Humanities. These e-proceedings comprise current researches that were undertaken with the rigorous endeavour of knowledge enhancement to ensure that the world of academia will continue to flourish. It is thus hoped that readers will significantly benefit from knowledge contained in these proceedings.

TeSSH I 2022 and these e-proceedings would not have been possible without the great efforts from the presenters, and the generous support from the TeSSH I 2022 committee members and the Rector of UiTM Cawangan Kedah, Prof. Dr. Mohamad Abdullah Hemdi. A heartfelt gratitude is extended to all involved. It is hoped that these e-proceedings will be an impetus to stimulate further studies and research that benefit the society at large.

TABLE OF CONTENTS

1	A Conceptual Paper on Factors That Affect the Shariah Compliance Auditing Among the Islamic Financial Institutions in Malaysia	1
	Saifulrizan Norizan & Marjan Mohd Nor	
2	A Qualitative Study of Entrepreneurial Intention Among UiTM Kedah Accounting Students During Covid-19 Pandemic	8
	Mazlifa Md. Daud, Noora'in Omar, Muhammad Hariz Hamid, Mohd Hafiz Hashim & Anwar Johari	
3	A Review on By-Laws of Alor Setar City Council (MBAS)	21
	Nor Zaini Zainal Abidin, Nur Irinah Mohamad Sirat & Nurul Mazrah Manshor	
4	Accounting For Agriculture in Malaysia: A Special Attention to Aquaculture	27
	Saifulrizan Norizan, Mohd Halim Kadri, Zarina Abu Bakar & Juyati Mohd Amin	
5	Age-Friendly Environment for Older People: Challenges and Plans	34
	Noorlailahusna Mohd Yusof & Suziana Mat Yasin	
6	Aplikasi Inovasi E2 Kit 1.0 Dalam Proses Pengajaran Dan Pembelajaran Litar Asas Elektrik	40
	Siti Rohaiza Zainol, Noor Aziana Abu Taib & Wan Nadirah Rosli	
7	Basic Of Differentiation Using Three Alternative Approach in Seberang Perai Polytechnic	50
	Siti Faridah Ismail, Rosila Adnan & Rohani Hamsan	
8	Bio Natural Food Seasoning from Eugenia Cephalanthum Using Dehydration Method	60
	Hidayah Julaihi, Theivya A/P Santhanasamy & Felicia Bong Lee Chen	
9	Cabaran dan Masa Depan Muzium Negeri Kedah	68
	Juaini Jamaludin	
10	Co-Integration Between Malaysia Stock Market, ASEAN and ASEAN Plus Three Countries During Pre and Post 14th Malaysia's General Election: A Short Run Analysis	72
	Anas Fathul Ariffin, Muhammad Akmal Hakim & Muhammad Hilmi Samian	
11	Computer Science Students' Learning Preferences, Mental Health, And Emotional Issues During Pandemic Covid-19 While Moving Towards Endemic	78
	Ahmad Faiz Ghazali, Noor Azrin Zainuddin, Ahmad Kamalrulzaman Othman & Yusnita Sokman	
12	Customer's Satisfaction: The Role of Food Quality, Service Quality and Ease of Website in Online Food Delivery	86
	Nur Afifah Aliah Husaini, Norhamizan Hamir, Rashid Salleh & Zamri Ahmad	
13	Digital inheritance: Legal Challenges in Malaysia	98
	Nor Azlina Mohd Nor & Ahmad Shamsul Abd Aziz	

14	Digital Literacy: Presentation Made Easy with ACE Alice Shanthi, Nur Izzah Jamil, Sheela Paramasivam, Siti Noor Dian Ahmad & Mohd Nur Fitri Mohd Salim	106
15	Diploma Students' Perceptions of Online Assessment: The Anchor That Holds Them in The ESL Classroom Jaqueline Susan Rijeng, Imelia Laura Daneil, Kimberley Lau Yih Long, Tang Howe Eng & Christine Jacqueline Runggol	115
16	Evolusi Tadbir Urus Dan Perundangan Wakaf Di Malaysia: Satu Analisis Rohayati Hussin, Mohd Zulhelmey Abdullah, Afiffudin Mohammed Noor & Farahdina Fazial	125
17	Exploring Strategies to Reduce Adolescents' Involvement in Risky Behaviours from The Perspective Of A Probation Officer Lina Mursyidah Hamzah, Sharifah Muzlia Syed Mustafa, Nurul Fitriah Alias & Norazah Abdul Aziz	142
18	Factors That Lead to Poor Mental Health of Social Media User among UiTM Kedah Degree Students Nur Elisa Aqila Amir Yusrie, Sarah Sabir Ahmad, Azfahane Zakaria & Mhd Azmin Mat Seman	147
19	How The Covid-19 Pandemic Has Increased the Risk of Compulsive Buying Behaviour And Online Shopping Addiction For Apparel Purchasing In Malaysia: An Overview Of Generation Y And Generation Z Normaziana Hassan, Basitah Taif & Rosita Mohd Tajuddin	155
20	Hubungan Antara Impak Teknologi Maklumat Dan Budaya Organisasi Dalam Kalangan Kakitangan FRIM Nor Arinah Mohamed Zemudin, Muhammad Badri Ishak, Nurul Madiha Mohd Ilham & Wan Nur Syazmira Wan Suhaimi	168
21	Inhibiting Factors to Successful Virtual Teaching and Learning in Engineering Science Topic from the Perspectives of Polytechnic Lecturers Nurul Ain Saipudin, Noorul Amilin Saipudin & Nornazira Suhairom	174
22	Inovasi Sosial Melalui Program Akademik Intensif untuk Pelajar STPM Aliran Sains Tercicir Marinah Muhammad, Wong Hie Ling, Aainaa Syazwani Mohamad Amir Hamzah & NoorJanatun Naim Jemali	183
23	Investigating the Usefulness of TikTok as an Educational Tool in Learning Chemistry Nur Farha Shaafi, Mohammad Mubarrak Mohd Yusof, Nurul Nabilla Mohammad Khalipah & Norhazly Mohd Hanif	187
24	IPQUEUE: Indoor Premises Control Using Quick Response (QR) Code for Covid-19 Pandemic Mohd Suffian Sulaiman, Zuraidah Derasit & Sharizah Shahar	200

25	Kajian Arah Kiblat Liang Lahat Lama Bagi Tanah Perkuburan Islam Syed Idrus Syed Salim & Nor Asmadi Asri	213
26	Keberkesanan Kaedah Masa Hakiki Sistem Penentududukan Sejagat Dalam Penubuhan Stesen Kawalan Kerja Ukur Tanah Asiah Abdul Satar, Nor Azme Nordin & Sulzakimin Mohamed	220
27	Kesediaan Pensyarah Sains Kejuruteraan Dalam Pelaksanaan Mini Projek Secara Hibrid Di Politeknik Tuanku Sultanah Bahiyah Nur Elyani Musa, Shamsul Arif Ismail & Azlina Hassan	229
28	Keunikan Partikel 'Lah' Dalam Terjemahan Surah Yasin di Malaysia Mohd Sufian Ismail & Anida Sarudin	238
29	LEVs As an Assessment Tool for Affective Domain In Laboratory Courses For Diploma In Civil Engineering Narita Noh, Noor Raifana Ab Rahim, Nur Zaidani Wati Mohd Darwis & Juwita Asfar	246
30	Measurements of Customer's Satisfaction towards Courier Services in Malaysia during Covid-19 among Students in UiTM Kedah Siti Nursyahirah Zaffendee, Sarah Sabir Ahmad, Azfahane Zakaria & Mhd Azmin Mat Seman	256
31	Measurements Of Depression Level Among Students in UiTM Kedah Adlin Mohd Anizam, Sarah Sabir Ahmad, Azfahane Zakaria & Syed Mohammed Alhady Syed Ahmad Alhady	264
32	Media Arts as An Art-Based Interventions in the Institutional Care Environment Raja Eda Shabina Raja Raimie, Mohammad Kamal Sabran & Nur Zaidi Azraai	270
33	Mengatasi Kesalahan Umum Yang Pelajar Lakukan Semasa Menjawab Soalan Peperiksaan Sains Kejuruteraan Nur Azilina Abdul Aziz, Koa Chee Hoon & Siti Aishah Azmi	279
34	Pelaksanaan Wakaf Air di Malaysia: Satu Tinjauan Tadbir Urus Dan Perundangan Nurul Mazrah Manshor, Rohayati Hussin, Syatirah Abu Bakar, Nur Irinah Mohamad Sirat & Salmah Roslim	288
35	Pembangunan MOOC Bagi Kursus Foundation Mandarin (Level II) Berpanduan Model ADDIE Ting Hie Ling	294
36	Pengaruh Budaya Merantau Terhadap Evolusi Seni Bina Rumah Tradisional Negeri Sembilan, Malaysia Mohamad Hanif Abdul Wahab, Azizi Bahauddin & Nor Aniswati Awang Lah	302
37	Pengesanan Graduan Kolej Komuniti Jelebu Ketika Pandemik Covid-19 Noor Aziana Abu Taib, Siti Rohaiza Zainol & Zainatul Fakhir Zainon	313
38	Penggunaan iPad Dalam Menambakbaik Interaksi Di Kalangan Pensyarah Dan Pelajar Bagi Kursus Matematik Kejuruteraan 1 Mohd Syukor Che Omar & Azlina Hassan	317

39	Penggunaan Video <i>YouTube</i> Dalam Pengajaran dan Pembelajaran Bahasa Mandarin: Satu Tinjauan Awal	328
	Lee Chai Chuen & Nor Azrina Mohd Yusof	
40	Penguatkuasaan Undang-Undang Dalam Menangani Penyalahgunaan Media Sosial di Malaysia	333
	Ahmad Shamsul Abd Aziz & Nor Azlina Mohd Nor	
41	Penyampaian Amalan Pengajaran Dan Pembelajaran (Laboratory Work) Secara Atas Talian Terhadap Pembelajaran Pelajar Diploma Geomatik Politeknik Sultan Haji Ahmad Shah	343
	Nur Aisah Ab Moin & Asiah Abdul Satar	
42	Pelaksanaan Ujian Pra Sebagai Alternatif Untuk Meningkatkan Pencapaian Markah Pelajar Bagi Kursus DBM20023 Matematik Kejuruteraan 2	351
	Siti Norhazlina Shafie & Rosila Adnan	
43	Persepsi Pelajar Terhadap Penggunaan E-Book Dalam Menyelesaikan Tugas Kajian Kes	359
	Farah Abdul Malek, Rohaida Abu Bakar & Liyana Murni	
44	Promoting Learner Autonomy Through Online Global Interactions Among ESL Students	365
	Sharina Saad, Rafidah Amat & Nor Asni Syahriza Abu Hassan	
45	Remote Learning in The Time of Post - Covid-19: The Conceptual Framework of An Interactive PdPR For Primary School Via Visual Basic Programming	380
	Aslina Omar, Samsiah Abdul Razak, Nur Insyirah Mohamad Radzi & Ini Imaina Abdullah	
46	Strategi Pembelajaran Bahasa Melayu dalam Kalangan Murid Cina di Sekolah Jenis Kebangsaan Cina	385
	Wee Kee Quan, Zamri Mahamod & Shamsul Aizuwani Nawi	
47	Stres Dan Kepuasan Kerja: Analisis Inferensi Faktor Gender Dan Status Perkahwinan Dalam Kepuasan Kerja Pensyarah IPG	397
	Punitha Muniandy, Khairani Zakariya, Azhar Mohd Ali & Ahmad Sukari Mohamad	
48	Student Satisfaction of Public Transportation at UiTM Kedah	408
	Muhammad Azizi Azizurrahim, Sarah Sabir Ahmad, Azfahane Zakaria & Mhd Azmin Mat Seman	
49	Sustainable Smart Retirement City: A Concept Paper	417
	Nazmi @ Nazni Noordin, Zaherawati Zakaria, Mohd Zool Hilmie Mohamed Sawal, Mohd Syahmizan Azmi & Adnan Aminuddin	
50	Teknik Retorik Lafaz-Lafaz Berkaitan Dengan Syaitan Dalam Al-Quran	425
	Muhamad Khairul Anuar Zulkepli, Burhanuddin Wahab, Ahmad Fauzi Yahaya & Mohd Zulkhairi Abd Hamid	
51	The Determinants and Impact of Social Media Content on Consumer Engagement	438
	Marha Abdol Ghapar, Azlina Shamsudin, Nazlin Emieza Ngah & Nur Dalila Adenan	

52	The Distraction That Affects Students Focus Nur Khalyda Kamarol Hisham, Sarah Sabir Ahmad, Azfahanee Zakaria & Syed Mohammed Alhady Syed Ahmad Alhady	446
53	The Effects of Varying the Duty Cycle to The Output Voltage in Buck Converter Nurhazwani Saleh	455
54	The Impact of i-Pulih Model Towards Methamphetamine Addicts Recovery in PUSPEN Tampin, Melaka Muhammad Dhamir Audi Azizul, Wan Munira Wan Jaafar, Azlina Mohd Khir & Samir Muhazzab Amin	462
55	The Implementation of National Education Assessment System in Malaysian Primary Schools Shanusi Ahmad, Nor Hasnida Che Md Ghazali & Mohd Nazir Md Zabir	473
56	The Influence of Leadership Style on Lecturer's Performance Azlina Shamsudin, Nalin Emieza Ngah, Marha Abdol Ghapar & Nur Dalila Adenan	481
57	The Internet Addiction (IA) Among Youth Generation Muhammad Arif Ikhwan Aminuddin, Sarah Sabir Ahmad, Azfahanee Zakaria & Mhd Azmin Mat Seman	487
58	The Relationship Between Curricular Activities Among Students' Leadership Syarifah Nur Bahirah Syed Jamalulil, Sarah Sabir Ahmad, Azfahanee Zakaria & Syed Mohammed Alhady Syed Ahmad Alhady	493
59	The Role Entrepreneurship Education in Moderating Intention to Be An Entrepreneur Among Students With Learning Disabilities In Malaysia Nazlin Emieza Ngah, Nur Dalila Adenan, Azlina Shamsudin & Marha Abdol Ghapar	504
60	The Usage of Open Green Space (Planting Strip Area) at the Perimeter of Terrace House Unit by The Residents: Case Study in Taman Sinar Intan, Sungai Petani Mohd Zikri Mohd Zaki, Nurul Izzaty Zulkipli, Ahmad Faisol Yusof & Tajul Edrus Nordin	511
61	The Use of Scaffolding in Helping Students Complete Tasks That Require Higher Order Thinking Skills Syakirah Mohammed, Fathiyah Ahmad @ Ahmad Jali, Robekkah Harun & Sharina Saad	525
62	Time Passed and How Much Time Is Left? A Study on Motivation to Graduate on Time (GOT) Nur Dalila Adenan, Marha Abdol Ghapar, Nazlin Emieza Ngah & Azlina Shamsudin	537
63	Underground Mapping for Islamic Mausoleum Syed Idrus Syed Salim, Nor Azme Nordin & Sulzakimin Mohamed	546

A Conceptual Paper on Factors That Affect the Shariah Compliance Auditing Among the Islamic Financial Institutions in Malaysia

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ABSTRACT

In Malaysia, shariah compliance audit is one of the crucial elements stated in the shariah governance framework to control and monitor the operations of Islamic Financial Institutions (IFIs). It is not an easy task to ensure that the shariah audit upholds Shariah principles and values. This is to make sure that compliance of IFIs' operations is practised when offering Shariah-compliant services. The main objective of shariah compliance auditing is to safeguard the interests of the stakeholders of IFIs such as account holders, shareholders, creditors, management, and employees, as well as the community at large, while ensuring proper and adequate mechanism of check and balance in place is tailored to the objectives and missions of its establishment as per the Maqasid al-Shariah. This study aimed to provide a review and analysis of Shariah audit compliance literatures by exploring the factors that affect Shariah audit compliance among the IFIs in Malaysia, such as the cooperation between internal and external auditors, the scope of the internal Shariah audit and qualification syariah auditors. This study contributes to the body of knowledge of Shariah audit compliance that would provide a more precise illustration to the IFIs on the importance of shariah compliance auditing in fulfilling the needs of stakeholders. Subsequently, it helps to maximise the benefits of shariah compliance auditing to their stakeholders as well as regulatory improvement in the future in minimising or reducing the occurrence of shariah non-compliance risk.

Key Words: Islamic Financial Institutions, Maqasid al-Shariah, Stakeholders, Shariah Principles and Values, Shariah Compliance Auditing

INTRODUCTION

In Malaysia, shariah audit is the primary function of ensuring Islamic financial institutions (IFIs) comply with Shariah principles. Every institution that operates should have contributed to achieving the objective of Islamic law – the *Maq'asid Ash-Shariah*. The examples of activities related to the concept of *shariah* auditing are system, products, employees, environment, and society. Shariah audit also plays a significant role in aspect monitoring and controlling the activities and operation of the IFIs. It has become a crucial function within organisations that arise from many financial scandals and corporate collapses. According to Khalid et al. (2018), a shariah audit is needed in a monitoring role due to the failure of large corporate scandals such as Enron and WorldCom. IFIs must invest and focus on internal auditing and improve internal shariah audit effectiveness in achieving organisational objectives. However, the fact is, the Islamic audit itself also possesses a lot of problems and challenges that need to be overcome, especially in Malaysia. According to Akbar et

al. (2015), aspects of the regulation, audit process, and human resources are factors that contribute to the severe problems in shariah audit.

There are several reasons why the Shariah audit is still a continuously relevant issue by researchers to date. First, the function of the Shariah audit in an organisation is considered significant, especially in the corporate governance framework. This is consistent with research done by Akbar et al. (2016). Shariah audit plays a substantial role in maintaining and ensuring the integrity of IFIs in carrying and implementing the shariah principle. Second, the effectiveness of shariah audit is a new research area in internal auditing that needs to be investigated by the researchers. Only a few studies have been researched extensively overseas, and few researchers such as Al Twaijry et al. (2003); Mihret and Yismaw (2007); Yee et al. (2008); and Endaya and Hanefah (2013) have proposed the necessity to conduct more research in developing countries such as Malaysia. According to Minarni (2013), shariah audit has a massive impact in ensuring compliance operation of the banks in accordance with shariah Islamic principle and rules. Shariah's principles and regulations are crucial in maintaining and enhancing sustainability, especially in bank operations (Rizqiani & Yulianto, 2020). Third, there is no comprehensive research or studies done by previous researchers regarding the factors that influence internal shariah auditing, especially in Malaysia. Research done by previous researchers such as Endaya and Hanefah (2013) mainly focused on the best framework for internal audit effectiveness, the relationship between internal Shariah audit characteristics and its effectiveness (Khalid et al., 2017), the needs and challenges (Rahman, 2008) of academicians and practitioners towards Shariah audit (Mulyany, 2008), professionalisation of Shariah auditor (Najeeb and Ibrahim, 2013), conceptualising the duties and rules of Shariah auditors (Othman et al., 2015) and audit framework for Shariah compliance (Shafii et al., 2010). A few studies focused on Shariah audit practices in IFIs, such as scope, competency, working methods, and the current framework used to perform a Shariah audit (Kasim & Sanusi, 2013; Yahya & Mahzan, 2012). However, the factors that affect the shariah compliance auditing among the IFIs in Malaysia have not been extensively studied compared to studies in external and internal audits in a conventional bank. This paper will explore the stakeholders' perspectives involved directly or indirectly with Shariah compliance auditing of IFIs, such as cooperation between internal and external auditors, scope of internal Shariah audit and qualification shariah auditors.

LITERATURE REVIEW

Shariah Compliance Auditing

Shariah compliance audits can be defined as periodic assessments that give an independent assessment and objective assurance meant to add value and increase the degree of compliance about IFI's business operations, with the main goal of establishing a sound and effective internal control system. Shariah auditing from Quranic can be defined as *"Thou, verily O man, art working toward thy Lord a work which thou wilt meet (in His presence). Then whoso is given his account in his right hand. He truly will receive an easy reckoning. And will return unto his folk in joy"* (Surah al-'Insyiqaq: Verses 6-9). According to Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI), shariah audit is described as an audit attestation for Shariah compliance in its most basic form.

Shariah Compliance Audit in Malaysia

Islamic banks, Takaful operators, Development Financial Institutions, and Islamic capital markets make up Malaysia's Islamic financial system. Bank Negara Malaysia (BNM), Malaysia's central bank, regulates Islamic banks, Takaful operators, and development financial organisations. Meanwhile, the Securities Commission (SC) of Malaysia regulates the capital market. Malaysia has two Shariah governance structures: one at the national level and the other at the industry level.

Shariah Enterprise Theory

Shariah Enterprise Theory (SET) is a theory that combines enterprise theory with the principle of Islamic value. SET is the combination of wealth or value-added to the community. Triyuwono (2006) stated that the distribution of wealth or value-added is applied to the direct parties that contribute to the company, namely shareholders, creditors, employees, and the government but try to focus on other indirect parties such as individuals that contribute to the financial growth and skills. While according to Meldona et al. (2019), this principle is based on human beings acting as *khalifatullah fil Ardh* that carry out the objective to create and distribute in terms of welfare for human beings and nature as a whole. SET also emphasises the concepts of justice in human beings and the natural environment in applying the Islamic principle in daily life. SET is the theory that gives advantages to all the parties who are using this concept. According to Triyuwono (2006), there are two (2) concepts of primary responsibility that were applied in this theory, namely vertical (ALLAH) and horizontal (human and natural environment). Meutia Inten (2006) stated that using the themes and items of social responsibility disclosure is essential in reducing the deity values, especially in Islamic banks.

Cooperation between internal and external auditors

Previous studies have conducted extensive research which focused on the coordination and cooperation between internal and external auditors in conventional financial institutions (Endaya, 2014; Ester Gras-Gil et al., 2012; Fowzia, 2010; Schneider, 2009; Morrill et al., 2003). The role of internal audit is an integral part of the corporate governance of organisations which aims to provide independent assessment on risk management, control, and governance processes (IIA, 2012, Sec.2100). On the other hand, external audit function is not part of the organisation's internal governance structure, but frequently engaged with internal audit function to assist them in providing an independent opinion to the shareholders on the truth and fairness of the company's financial statements. The internal audit function may influence overall risk assessment, including nature, timing, and extent of annual auditing procedures conducted by the external auditor through the process of understanding the company's internal control systems and collecting all substantive evidence. Having a good relationship and cooperation between internal and external audit functions may help the governing body to obtain an in-depth understanding of the company's operations and risks while eliminating areas of possible duplication of audit work (Alqudah, Amran, and Hassan, 2019). Effective communication among internal and external audit functions is needed to ensure that their cooperation can be of benefit to the effective governance of the organisations they serve (Fowzia, 2010).

While many previous studies have examined internal and external audit functions in the banking sector, the study of internal Shariah audit in Islamic Financial Institutions (IFIs) is still lacking (Algabry et al., 2020; Khalid et al., 2018) and yet to be extensively studied in previous research especially in the context of Malaysian practice. The cooperation between internal and external audit functions is essential and should be explored further on the potential risk that may negatively affect the results of the mutual efforts between them (Fowzia, 2010; Thnaibat & Shunnaq, 2006). There have been previous examples of actual misconduct and failure cases of the Islamic banking sector that require attention to ensure good governance. For example, the Bank of Credit and Commerce International (BCCI) was found guilty by its external auditors. It systematically defrauded its auditors over a few years by falsifying accounts to hide the losses and show healthy reserves (Kanas, 2005). Another finding was a failure case of five IFIs that had deposited significant resources into Bank of Credit and Commerce International with the promise that they would be invested in commodity contracts in accordance with the Shariah principles. However, it was later revealed otherwise (Grais and Pellegrini, 2006a). In another fraud case that occurred in IFI, Bank Shariah Mandiri was found to be involved in falsifying key documents, with potential losses reaching up to Rp. 102 billion.

A solid internal control system can often foster a good governance approach to detect and prevent any potential fraud in the organisation. It is essential for IFIs to ensure that they are Shariah-compliant, and this can be accomplished by strengthening the Shariah governance system, which

is comprised of four pillars: first, management and supervision; second, the Shariah Advisory Board; third, Shariah compliance and review, and lastly, transparency and disclosure (Haqqi, 2014). The internal control system is a critical area in which it is audited annually by an external auditor. By doing this practice, the poor governance system in IFIs could be prevented. Grais and Pellegrini (2006b) highlighted that the involvement of external and internal arrangements is suggested to monitor the effectiveness of Shariah compliance. In other words, it is necessary to have cooperation between the external and internal audit function (Hijazi, 2010) to ensure high-quality audits and minimise doubled efforts. Basically, the objective of the internal Shariah audit function is similar to the audit function in conventional financial institutions. The differences, however, emerged based on Auditing Standard No.1 for Islamic Financial Institutions (ASIFI), which highlights that Shariah auditing provides an independent assurance that the Islamic banking's transactions are in line with Shariah principles and rules, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) standards, as well as the national accounting standards.

Malaysia is currently focused on the implementation of the Shariah audit after Bank Negara Malaysia (BNM) has imposed mandatory action on the shariah audit function after ten years of the issuance of the Shariah Governance Framework (SGF) in 2010 (BNM, 2010). It was later revised to the Shariah Governance Policy Document (SGPD 2019). This mandatory action imposed has made Shariah audit to function as one of the compliance functions that is required in IFIs in addition to Shariah Review, Shariah Research, and Shariah Risk Management (Isa, Ariffin, and Abidin, 2020). Nevertheless, many have argued that SGF 2010 was not properly documented with adequate explanations and guidelines specifically for the internal auditor to perform their effective Shariah audit (Abdul Ghani & Abdul Rahman, 2015; Abdul Rahman, 2014; Shafii et al., 2013; Shaharuddin, 2011). PwC (2011) raised an urgent need to establish a proper Shariah audit framework and standards, enhance the methodology of Shariah audit as well as encourage the involvement of auditors with the right competencies and qualifications in conducting Shariah audit. The credible performance of the Shariah audit is the key element to building various stakeholders' confidence in the industry.

Scope of internal Shariah audit

The scope of the internal shariah audit is vital in ensuring all the Islamic rules and principles are obliged by IFIs in carrying their daily activity and operation in their business. The conventional scope of an internal auditor is mainly different from internal shariah auditor in terms of implementing Islamic rules and principles. In the conventional practice, internal auditor is dependent in terms of aspects such as the assessment of financial statement and organisation's governance and management controls (Messier et al., 2008; Raiborn et al., 2017; Roussy, 2018). Meanwhile, according to Sultan (2007,2011), the scopes of internal shari'ah auditors are to check whether all the activities obliged with Islamic rules and principles or not, such as transactions, products, policies and procedures, agreements and contracts, and financial statements and reports (Sultan, 2007; Hanif, 2011). In the financial sector, auditing techniques come from traditional auditing that focuses more on aspects such as socio-economic infrastructure and the culture of Islamic society (Kamaruddin & Hanefah, 2018). According to Algabry et al. (2020), the objective of shariah auditing is similar to concepts in traditional financial institutions. However, the main differences arise in whether or not IFIs follow the rules and principles of national accounting standards.

Internal Shariah auditor has a broader scope compared to the conventional internal auditor in carrying out their daily activities and operations. According to Kasim et al. (2013), internal shariah auditor has a broader scope because it mainly concentrates especially on the details of the operation as a whole in order to express an opinion regarding the current situation that relates to the compliance with the Shari'ah guidance and fatwas issued by its Shari'ah committee. Any information exposed to shariah audit risk should be audited by a competent auditor to ensure the accuracy of information such as a person, product, financial statements, policies and procedures, and many more. The effectiveness of the auditing process can be enhanced via transparency where the auditor can provide sufficient evidence in order to make sure the organisation obliged with the principles of Shari'ah and the fatwas issued by its Shari'ah supervisory board (SSB). The main reason external

auditors are more preferred than internal auditors is that they can help internal auditors express unbiased audit opinions on the financial statement audit (Graiss and Pellegrini, 2006; Khalid et al., 2018).

Qualification Shariah auditor

Shariah auditing should only be carried out by qualified internal and external auditors with sufficient knowledge of Shariah, Islamic finance, and other necessary background. According to empirical evidence, the majority of shariah auditors in Islamic banks are inexperienced and lack professional or academic qualifications in either Islamic banking or shariah (Mahzan & Yahya, 2014). Furthermore, previous research has not established the specific knowledge, skills, and other characteristics (KSOC) that shariah auditors must possess to perform the shariah audit role effectively. This condition necessitates the creation of KSOC, or a single body of knowledge for shariah auditors. As a result, the market will have a clear knowledge of what qualifies as a competent shariah auditor, and a certification mechanism for shariah auditors will be developed. As a result, the shariah auditing profession can rise to prominence in the market.

According to Mohd Ali et al. (2014), shariah auditors will gain more exposure through shariah certified training programmes conducted by established organisations such as IBFIM, continuing professional development (CPD) from professional bodies such as the Malaysian Institute of Accountants (MIA), and in-house trainings provided by senior shariah auditors in the respective Islamic banks, in addition to in-house trainings provided by the respective Islamic banks senior shariah auditors. Furthermore, higher education institutions should consider including shariah audit, as well as other Islamic financial courses, in the undergraduate curriculum to prepare students for careers as shariah auditors. This is line with study as suggested by Karim & Shetu (2020) which stated that more competent and experienced Shariah Auditors will attempt to better handle the Shariah agency problem and help to the establishment of good governance in Islamic financial institutions. Regulators, the government, Shariah scholars, and, most all, the Muslim community should make a concerted effort to move this issue forward.

SIGNIFICANCE OF SHARIAH AUDIT

Nowadays, shariah auditing is becoming increasingly important in ensuring that Islamic banks perform well in accordance with Shariah principles. Kasim et al. (2009) investigated the need for Shariah Audit initially. The main goal of Shariah auditing, or any type of auditing, is to ensure a clean and effective internal control system for Shariah consent. With respect to compliance with Islamic Financial Institutions laws and regulations, an independent and periodic assessment is required to ensure value and reliability (Khalid et al., 2018). Shariah Audit is used by organisations that follow Islamic laws and regulations to ensure the integrity and cleanness of their internal financial condition, as well as the public's expectation that they are conducting business in accordance with Shariah law (Radzi, 2018).

CONCLUSION

Shariah compliance is significant for daily activities and functions of IFIs because it has a huge impact, especially in financial activities and principles against the Shariah rules. In conclusion, there are still issues in Shariah compliance auditing from the aspect of Shariah, such as the magnitude of the internal Shariah audit unit, cooperation between internal and external auditors, and the scope of internal Shariah audit. Therefore, it is important for relevant parties to act in order to close the gap that will have a significant impact on the stakeholders' confidence primarily related to the Shariah compliance of the IFIs' products and services on its operations and activities.

This paper is purely based on the review of literature from previous researchers. The need for an effective Shariah audit is vital in business activities or functions because it ensures that the IFI's

will follow the shariah principle. Indirectly, relevant regulators need to establish solid and sound guidelines and frameworks for the IFIs to implement Shariah audits in their activities properly.

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